

SM/13/167  
Correction 2

July 10, 2013

To: Members of the Executive Board

From: The Secretary

Subject: **2013 Pilot External Sector Report**

The attached corrections to SM/13/167 (6/20/13) have been provided by the staff:

#### **Mischaracterizations of the Views of the Authorities**

**Page 14, fourth bullet, line 3:** for "Following Japan's introduction of quantitative monetary easing"  
read "Following Japan's introduction of quantitative and qualitative monetary easing"

#### **Evident Ambiguity**

**Page 27, second bullet, lines 9–12:** for "Over the medium-term, if the other key arrows of the strategy—namely fiscal consolidation and structural reforms to open up product markets and raise labor supply—are implemented in a comprehensive and credible way, the expectation is that the current account/currency could well move to levels broadly consistent with fundamentals."  
read "Over the medium-term, if the other key arrows of the strategy—namely fiscal consolidation and structural reforms to open up product markets and raise labor supply—are implemented in a comprehensive and credible way, the expectation is that the current account/currency could well move to levels broadly consistent with fundamentals and therefore the Yen's recent depreciation is not seen as necessarily problematic." Corrects for evident ambiguity between the ESR and the forthcoming Article IV report.

#### **Factual Errors Not Affecting the Presentation of Staff's Analysis or Views**

**Page 19, para. 18, lines 7–8:** for "...the central bank intervened to support the one-sided peg..."  
read "...the central bank intervened to support the floor..." Corrects the description of Switzerland's exchange rate regime.

### Typographical Errors

**Page 27, second bullet, lines 7-9:** for "While the real exchange rate currently appears moderately undervalued relative to fundamentals, this results from the critical (and welcome) attempt to decisively exit from deflation."  
read "While the real exchange rate currently appears moderately undervalued relative to fundamentals, this results from the critical and welcome attempt to decisively exit from deflation."

**Page 42, Appendix I, Table A1, Turkey current account:** for "-5.9 percent of GDP"  
read "-6.1 percent of GDP"

Questions may be referred to Mr. Robinson, AFR (ext. 35691), Mr. Phillips, RES (ext. 37187), and Ms. Stuart, SPR (ext. 37897).

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

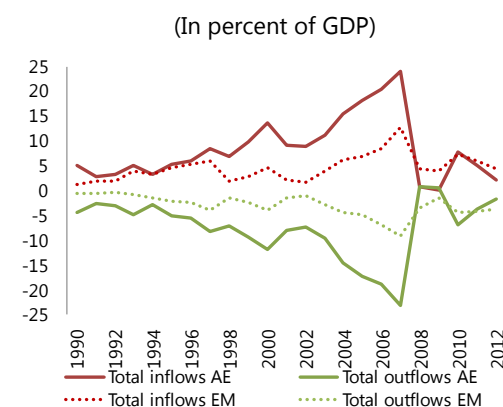
Att: (4)

Other Distribution:  
Department Heads

## B. Capital flows are lower in aggregate, but volatile, causing policy challenges for recipient countries

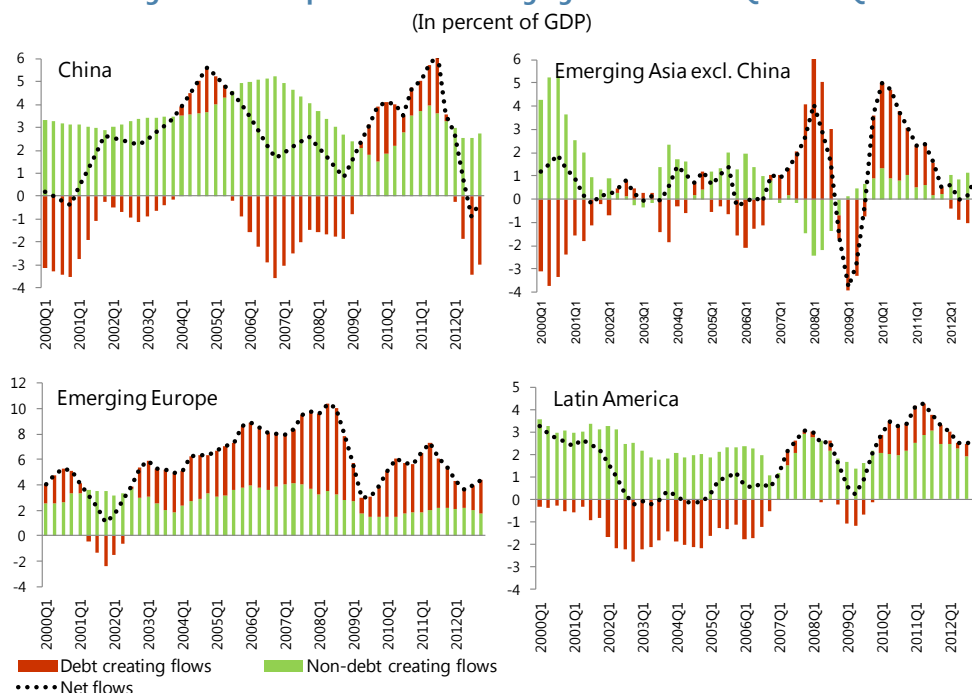
9. **Capital flows also declined on a gross basis during 2012, remaining well below the levels seen before the onset of the global financial crisis in 2008.** The spike in gross capital flows in the lead up to the crisis reflected an acceleration of cross-border transactions, especially within the euro area, in line with a general trend towards further financial integration (Figure 6). Flows among AEs have not recovered, reflecting the continued fragmentation of financial markets. Flows to emerging markets (EMs) as a group have also not regained the pre-crisis high.

**Figure 6. Gross Capital Flows to Advanced Economies and Emerging Markets**



Sources: IMF Balance of Payments Statistics, IMF WEO and staff calculations

**Figure 7. Net Capital Flows to Emerging Markets 2000 Q1–2012 Q4**



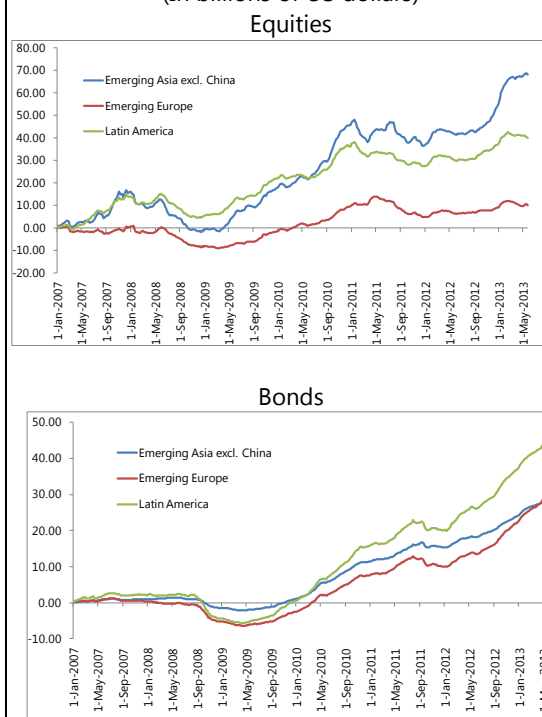
Sources: IMF Balance of Payments Statistics, IMF WEO and staff calculations.

10. **Some EMs have continued to see significant volatility in debt-creating flows, while foreign direct investment flows have been more stable** (Figure 7). Asian markets in particular have seen large fluctuations in net debt creating flows as risk sentiment has shifted. Focusing just on

bond and equity market flows (Figure 8), high frequency data point to four distinct periods of portfolio flows:

- **International investors returned to EMs in 2009.** Stronger growth prospects and higher interest rates in EMs contrasted sharply with the situation in AEs, handicapped by deleveraging and slowing growth.
- **Sentiment towards EMs, and the pattern of private capital flows, turned in the summer of 2011.** Risk aversion increased in the face of a combination of European debt concerns, a strong increase in commodity prices leading to fears of inflation, and slowing economic growth in some EMs. The VIX reached its highest level since the peak of the 2008 crisis. Capital flows to EMs slowed, with investors focusing on safe haven countries including several smaller AEs (Box 4).
- **International investors returned to EMs in the last quarter of 2012.** Risk aversion related to tail risks in the euro area receded following the introduction of the ECB's outright monetary transactions (OMT) program. Loosening of monetary conditions through the U.S. Federal Reserve's third quantitative easing and historically-low interest rates in safe havens pushed investors back to EMs in their search for yield. In addition, an improved growth outlook for emerging Asia was another factor that may have influenced flows.
- **In April and May, investor sentiment improved for the U.S. and Japan with a shift in flows to AEs.** Following Japan's introduction of quantitative and qualitative monetary easing and positive surprises on growth in Japan and the U.S. in 2013 Q1, there has been a steadying of flows to EMs with investors switching into equities in AEs. Market perception of an earlier than previously anticipated tapering off of quantitative easing in the U.S. resulted in a sell-off in some EM assets in late May.

**Figure 8. Cumulative Weekly Equity and Bond Flows to Emerging Markets 2007–13**  
(In billions of US dollars)

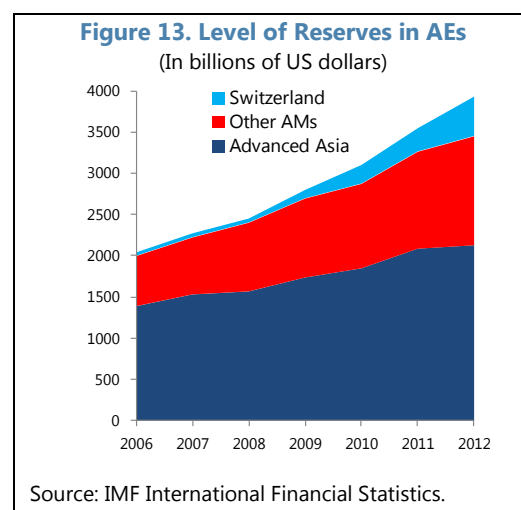


Sources: Haver Analytics and EPFR.

## C. Reserve accumulation has responded to the pattern of capital flows—with significant increases in some smaller advanced economies

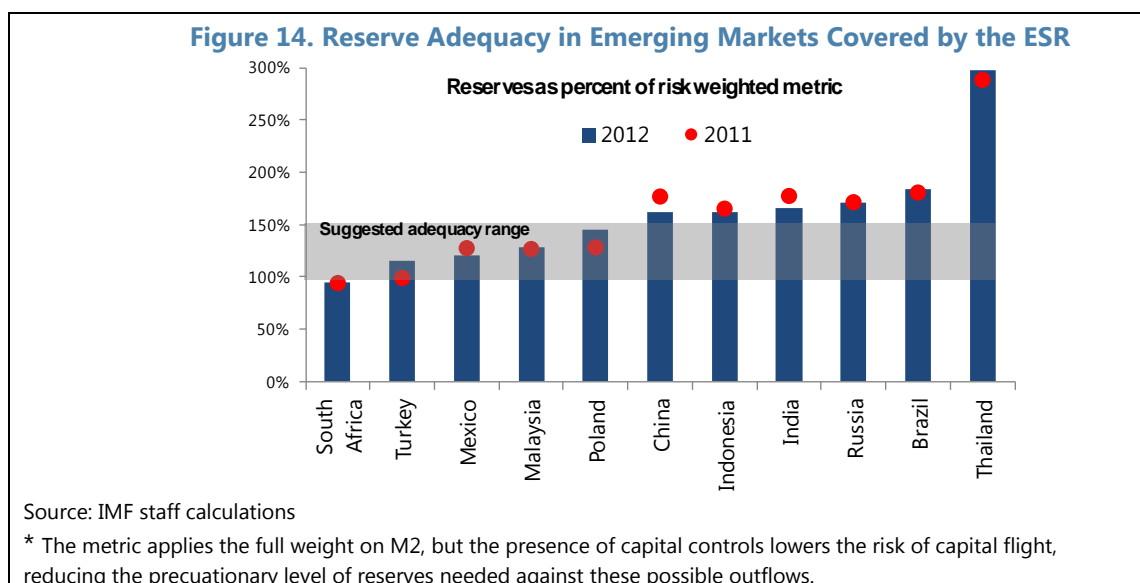
### 18. The pattern of reserve accumulation in 2012 reflected the incidence of capital flows. As

capital inflows to EMs slowed in 2012, intervention also declined. By contrast, the pace of reserve accumulation accelerated in countries with safe haven status. For example, reserve growth in Switzerland accelerated as the central bank intervened to support the floor introduced after a strong appreciation (Figure 13).



### 19. Reserve adequacy calculations for 2012 are broadly unchanged compared with 2011 (Figure 14). A

few EMs did see an acceleration in reserve accumulation in 2012 (e.g. Poland, Russia, Thailand, and Turkey). Rising liquid domestic assets, which could result in capital flight (proxied by broad money), was the main driver of the change in the metric (Figure 15). Due to the relative weakness in capital inflows in the year as a whole, there was little increase in short-term debt and portfolio liabilities.



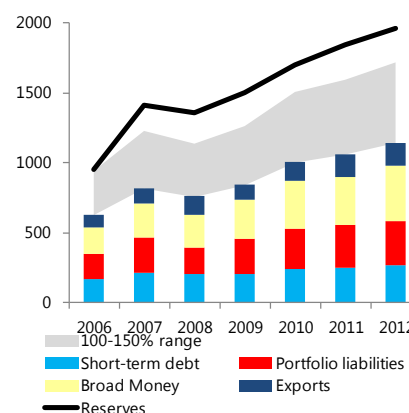
20. **Reserve accumulation in both advanced and emerging markets has been underpinned by a range of motivations (Annex II).** The precautionary motive remains an oft-cited reason for holding reserves, although this is not the only motive. For example, smoothing exchange rate volatility and saving resource-related revenues motivate accumulation by some EMs. For some AEs and EMs, rising external liabilities and reliance on short-term external bank funding raise new challenges as central banks may need to step in to ensure solvent local institutions have sufficient

foreign exchange liquidity if these markets become dysfunctional. For these countries, there may be a case to use reserves to provide foreign exchange liquidity to the domestic banking sector in the event of a crisis. For example, Sweden has recently announced that it will increase its foreign exchange reserves through borrowing to provide a buffer against financial shocks—such support comes with a cost to the central bank (the cost of holding additional reserves) and should be compensated by potential users.

21. **The precautionary motive for reserve accumulation can be lessened to the extent that alternative funding is available in the event of a systemic crisis.** For example, the US Federal

Reserve created swap lines designed to provide foreign central banks with the capacity to deliver U.S. dollar funding to institutions in their jurisdictions during times of market stress, while preventing the spread of strains to other markets and financial centers. The swap lines were designed to complement central banks' own reserves during the global financial crisis. Non-USD swap lines were also arranged between AEs. China also established a number of renminbi swap lines across many advanced and emerging economies, with the current outstanding size of around 2 trillion renminbi. In May 2012, members of the Chiang Mai Initiative (CMI) agreed a doubling in the size of the CMI Mechanism to provide significantly increased access to resources if needed. The IMF's Flexible Credit Line and Precautionary and Liquidity Lines can also complement reserves. However, to the extent that economies are not confident that such swap lines might be available in the future or are uncertain about the amounts that will be available, then they are more likely to continue to hold reserves for precautionary purposes.

**Figure 15. Composition of the IMF's Reserves Adequacy Metric Excluding China**  
(In billions of US dollars)

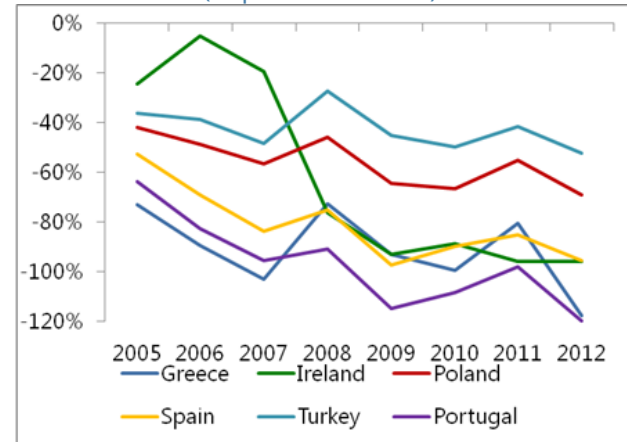


Source: IMF Staff Estimates.

- **The external sustainability approach highlights the need for a narrowing of current account deficits for a number of economies with high negative NFA positions.** For

economies in the euro area with high negative NFA positions, small current account surpluses (Portugal and Spain), or small deficits (Greece and Ireland), would be needed over the medium term to generate a significant improvement in the NFA position. Although current accounts narrowed in 2012 and surpluses were recorded in Ireland and Portugal, NFA positions continued to widen in some countries as current accounts remained weaker than their NFA/GDP-stabilizing levels, amid low or negative output growth in some cases. In Turkey, the composition of the IIP has deteriorated in recent years, with short term liabilities accounting for a growing fraction of total liabilities.

**Figure 21. Net Foreign Assets**  
(In percent of GDP)

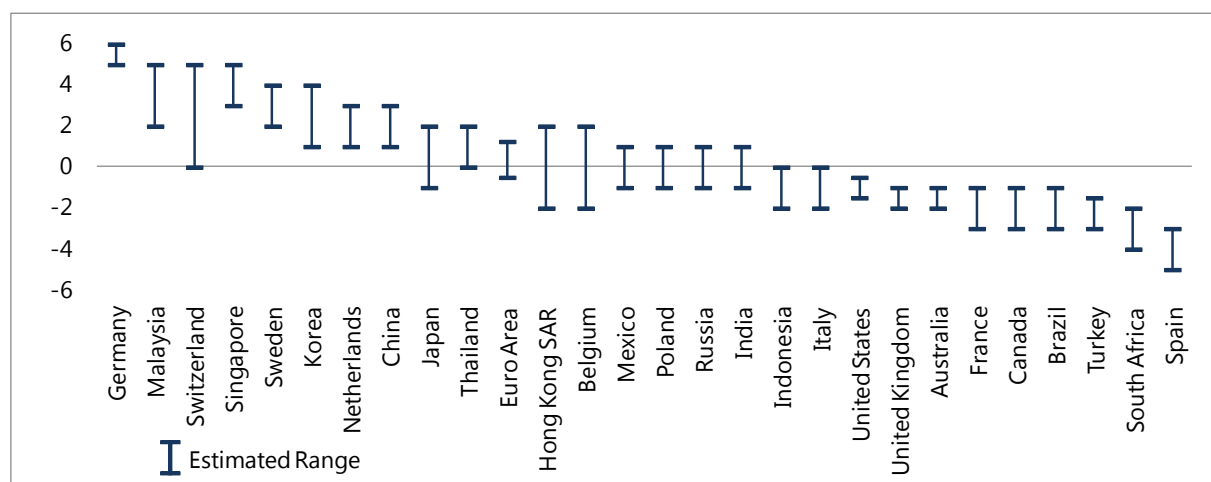


Sources: IMF International Financial Statistics and IMF staff

- **Recent major changes to Japan's macroeconomic framework make an assessment of the external position subject to an unusual degree of uncertainty.** The depreciation of the yen since 2012Q3 likely reflects both a dissipation in safe haven flows and the fundamental changes to the policy framework which are hard to disentangle (as well as other factors such as higher energy imports following the great Japan earthquake of 2011). The substantial changes to the policy framework may also have far reaching effects on expectations, inflation, and growth. While the real exchange rate currently appears moderately undervalued relative to fundamentals, this results from the critical and welcome attempt to decisively exit from deflation. Over the medium-term, if the other key arrows of the strategy—namely fiscal consolidation and structural reforms to open up product markets and raise labor supply—are implemented in a comprehensive and credible way, the expectation is that the current account/currency could well move to levels broadly consistent with fundamentals and therefore the Yen's recent depreciation is not seen as necessarily problematic.

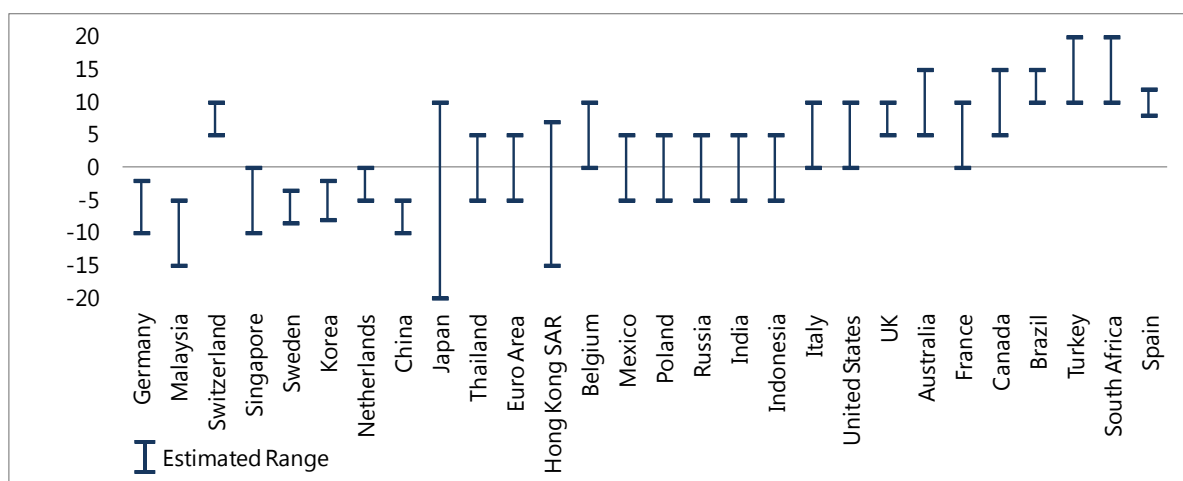
**Figure 22. Estimated Differences between Cyclically-Adjusted Current Accounts and those Consistent with Fundamentals and Desirable Policies**

(In percent of GDP)



**Estimated Differences between Real Effective Exchange Rates and those consistent with Fundamentals and Desirable Policies**

(In Percent)



Source: IMF Staff calculations (see Figure 18 for details).



emerging market economies, is that current account balances tend to be lower in economies with a lower level of productivity and income—as economic theory would suggest would be optimal if those economies have a higher expected rate of return on investment—but also that the strength of this pattern depends on the extent to which policies permit capital flows. Accordingly, a relatively poor economy that is also open to capital flows would tend to have a higher investment rate and a lower current account. (Such an economy would also have a more appreciated exchange rate, but that channel is offset by the Balassa-Samuelson effect, in which less-advanced economies have lower prices of non-tradable goods and lower real exchange rates. The EBA regression is now able to pick up each of these effects.)

7. ***Exhaustible resources of oil and natural gas.*** The revised EBA model captures the tendency of countries with energy resource wealth to have current account surpluses, relating this pattern to country's motivation to save a portion of its income in recognition of the exhaustible nature of that wealth. For all EBA countries that are net exporters of oil (or natural gas, not previously considered by EBA), current accounts are thus positively related not only to the size of such exports but also to their "temporariness," as measured by the ratio of production to the stock of proven reserves.

8. **The recent effort to enhance the EBA model also explored other areas, with emphasis on structural policies and financial factors (beyond those already modeled in EBA).** Among financial variables, only the private credit variable discussed above was found to be robustly related to current accounts and exchange rates. (See the EBA methodology paper for a description of the hypotheses and data explored.) The lack of strong findings in those areas is not entirely unexpected, in light of the available literature and of data shortcomings, but of course does not mean that such effects do not exist. Structural policies, for example, might have important effects on the speed at which external adjustment occurs, or one-time effects on the investment rate, or sustained effects on both saving and investment, but these may be difficult to detect in a panel regression.

## Appendix I. Supporting Charts and Tables

**Table A1. Summary of External Position Indicators**

Country	2012 Current Account		2012 Net Capital Flows		2012 Reserves Increase	2012 Net Foreign Assets*	Reserve Stock		Estimated Change in REER	Estimated Change in REER
	USD Billions	Percent of GDP	USD Billions	Percent of GDP	USD Billions	Percent of GDP	Ratio to Debt Securities & Other Investment, 2011, Percent	IMF Metric, EMs Only, 2012 Percent	Percent, Dec 2011 to Dec 2012	Percent, Dec 2012 to May 2013
Australia	-56	-3.7	56	3.7	0	-59	4		3.5	-2.2
Belgium	-2	-0.5	6	1.2	1	67	3		-0.5	0.1
Brazil	-54	-2.3	91	3.8	21	-31	83	183	-8.7	7.6
Canada	-67	-3.7	65	3.6	-2	-16	6		2.4	-1.4
China	193	2.3	-97	-1.2	97	21	351	161	1.1	6.5
Euro area	145	1.2	-132	-1.1	13	-8	7		-1.5	0.7
France	-63	-2.4	99	3.8	5	-19	4		-1.3	0.6
Germany	238	7.0	-300	-8.8	2	41	5		-0.9	0.7
Hong Kong SAR	6	2.3	16	6.2	24	278	33		1.3	3.3
India	-93	-5.1	90	4.9	-3	-15	90	166	4.3	6.5
Indonesia	-24	-2.7	25	2.8	0	-38*	56	162	-4.6	6.0
Italy	-11	-0.5	18	0.9	2	-26	8		-0.4	0.5
Japan	59	1.0	-108	-1.8	-38	57	42		-10.4	-17.0
Korea	43	3.8	-32	-2.7	12	-9	78		6.6	-0.1
Malaysia	19	6.1	-7	-2.4	1	4*	93	128	2.0	4.7
Mexico	-9	-0.8	44	3.7	18	-40	48	120	8.9	7.8
Netherlands	65	8.3	-65	-8.4	0	51	2		0.0	1.4
Poland	-17	-3.5	27	5.6	11	-69	40	145	8.4	-0.9
Russia	81	4.0	-56	-2.8	30	7*	108	172	5.4	2.8
Saudi Arabia	177	24.4	-9	-1.2	112	87*	900		0.6	4.5
Singapore	51	18.6	-13	-4.5	26	228	24		8.3	0.8
South Africa	-24	-6.3	24	6.3	1	-7*	54	95	-2.3	-2.9
Spain	-14	-1.1	1	0.1	3	-96	2		0.3	0.2
Sweden	38	7.1	-27	-5.2	-1	-16	7		0.8	1.8
Switzerland	85	13.4	124	19.6	208	154	28		-1.6	-1.8
Thailand	3	0.7	11	3.1	5	-9*	204	298	3.8	6.9
Turkey	-47	-6.1	66	8.3	21	-52	28	115	10.4	3.7
United Kingdom	-91	-3.7	94	3.9	9	-36	1		4.2	-2.8
United States	-475	-3.0	411	2.6	4	-28	4		-1.4	2.3

Sources: Current Account, net capital flows (measured here as changes in the capital and financial accounts (excluding reserve assets, and excluding net errors and omissions), and change in reserves from April 2013 WEO with IMF staff updates where available.

Net foreign assets from the IMF's International Financial Statistics, and with updates from Lane and Milesi-Ferretti, External Wealth of Nations database. REERs from the IMF's Information Notification System.

\* Net foreign asset data are in USD. Numbers with asterisks are for 2011. Others are for 2012. Ratios may differ from local currency ratios due to differences in average and end of period exchange rates.